Senate Inquiry into Bank Funding Guarantees

Submission by

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According to the Treasury, the Government guarantees are designed to promote financial system stability and ensure the continued flow of credit throughout the economy at a time of heightened turbulence in international capital markets.

The guarantees apply to authorised deposit-taking institutions (ADIs) incorporated in Australia, which as a group, are of systemic importance to the functioning of the financial system and the broader economy, and which are subject to prudential regulation by the Australian Prudential Regulation Authority (APRA) in accordance with international standards.

According to the Treasury,[2] "recent developments in international wholesale funding markets have restricted the ability of Australian financial institutions to access funding, with potentially serious implications for liquidity and lending activity." It is hard to square this rationale with the oft-repeated claims by the Government that Australia is in one of the least affected nations by the global crisis with one of the world's most profitable banking systems.

The Treasury document goes on to state: "To address these pressures, the guarantees are designed to assist Australian banks, credit unions and building societies to continue to access funding in domestic and international credit markets. The guarantees are also *designed to ensure that Australian institutions are not placed at a commercial disadvantage vis-à-vis their international competitors that have received similar government guarantees on their bank debt*." [Emphasis added] This is an exceedingly disingenuous argument, essentially to protect Australian banks from low-cost competition from foreign banks that have been decimated and many bankrupted by the global crisis.

Does the Treasury envisage that U.S., U.K. and global banks, many of whom are still in receipt of billions of TARP funds in order to keep them afloat, are going to rush in and do such a good undercutting both Australian banks and these banks own affiliates or subsidiaries by funding Australia's own recovery so effectively that local banks will be put in jeopardy? If so, I would only applaud.

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[2] http://www.treasury.gov.au/documents/1431/PDF/Design_and_operational_parameters_281008.pdf

This protection extended to the major banks is, however, consistent with Government encouragement of the major banks to absorb the next layer of banks, St George, BankWest, RAMS, Aussie and Wizard, and thus further establish the Australian banking system as probably the most concentrated in the world, thus hampering the growth of competition. There has been a long history of bank protectionism in Australia. The Hawke-Keating Government's adoption of the Campbell Committee reforms was supposed to put a stop to this. For example, when Professor Fin Crisp was chair of the then government-owned Commonwealth Bank he boasted that the bank had two million accounts all of which lost money.

In its own terms the funding guarantee has been a huge success. Since last October when the scheme was first introduced over $108 billion of guaranteed bank debt has been issued (Clancy Yeats and Eric Johnston, *SMH*, July 28, 2009). Australia with its tiny share of World GDP has always had ambitions to rival the largest and richest nations on earth. In terms of global guaranteed borrowing, Australia ranks fourth behind the U.S. (AUD $333 billion), followed by France and then Britain. Likewise, in terms of Keynesian stimulus spending we are right up there with the big nations according to the OECD despite having almost full employment and as noted by the Government, one of the least affected nations on earth.

Table 1. The absolute size of fiscal packages (revenue and spending measures) for the Top Six Countries

2008-2010, in absolute USD millions

Country	Amount	% GDP
USA	804,070	5.4
Germany	107,789	3.0
Japan	99,992	2.5
Canada	61,551	4.2
Spain	56,754	4.2
Australia	45,673	4.8

Source: OECD, Policy Responses to the Economic Crisis: Investing in Innovation for Long-Term Growth, June 2009. http://www.oecd.org/dataoecd/59/45/42983414.pdf

The Reserve Bank/APRA submission to the Senate inquiry noted that the rate of 70 basis points annually as the fee for the AA-rated major banks was lower by between 20 to 40 basis points than the rates being paid by comparable overseas banks. Moreover, the rates of between 100 (A-rated) to 150 (BBB and unrated) basis points being paid by smaller institutions was much higher than for comparable overseas banks (see Clancy Yeats and Eric Johnston, *SMH*, July 28, 2009).

Should governments be in the business of guaranteeing loans? In my view there was never any justification for the Australian Government to be subsidising wholesale bank loans. In fact, in my

view (Swan, 2009[3]) the subprime crisis was almost purely the creation of U.S. governmental policies designed with the laudable aim of encouraging home ownership and stimulating the housing market. In fact, many of the Government's policy responses to the crisis, cheap credit availability and subsidised first home buyer schemes, potentially duplicate the sorts of conditions that gave rise to the subprime crisis in the first place.

The continued operation of the loan guarantees is especially problematic at the moment when it is apparent that the crisis is not nearly as bad as it was painted in alarmist commentary by Australian politicians. The reason is that such subsidies simply generate very predictable "moral hazard" behaviour on the part of the recipients. This is even apart from the potentially huge cost to the taxpayer when default occurs. Fortunately, this has not yet happened in Australia and hopefully will not.

Moral hazard refers to the alteration to behaviour induced by the subsidy due to the taxpayer taking over the lender's liabilities.

This moral hazard behaviour is well illustrated by a recent table released by the New York Attorney General showing how the bank recipients of bailout TARP funding in the U.S. have abused the subsidy by paying huge bonuses to staff.

Table 2: TARP Recipients 2008 Bonus Payments

Bank	Earnings (Losses) $ (b)	Bonus Pool $ (b)	# of Employees	Earnings/ Employees	Bonus/ Employees	TARP $(b)
Bank of America	4.000	3.300	243,000	16,461	13,580	45
Bank of New York Mellon	1.400	0.945	42,900	32,634	22,028	3
Citigroup, Inc	(27.7)	5.330	322,800	(85,812)	16,512	45
Goldman Sachs Group	2.322	4.823	30,067	77,228	160,420	10
J.P Morgan Chase &Co	5.600	8.693	224,961	24,893	38,642	25
Merrill Lynch[a]	(27.6)	3.600	59,000	(467,796)	61,017	10
Morgan Stanley	1.707	4.475	46,964	36,347	95,286	10
State Street Corp	1.811	0.470	28,475	63,600	16,505	2
Wells Fargo & Co.[b]	(42.933)	0.978	281,000	(152,786)	3,479	25
Total	(81.393)	32.614	1,279,167	(63,630)	25,496	175

[a]According to a report by Walter Hamilton in *SMH* 5/08/09, the Bank of America had agreed to pay even more than U.S.$3.6b in bonuses to Merrill Lynch staff, namely U.S.$5.8b, when it acquired Merrill Lynch. At the time it did not disclose any agreement to pay bonuses to shareholders and has promised U.S.$33m to settle allegations of non-disclosure.

[b]Note that Wells Fargo losses included Wachovia's 2008 losses.

Source: Andrew M. Cuomo, *"No Rhyme or Reason: The "Heads I Win, Tails You Lose" Bank Bonus Culture* , August 2009

[3] Peter L. Swan, "The political economy of the subprime crisis: Why subprime was so attractive to its creators," *European Journal of Political Economy 25* (March, 2009), 124-132.

The table shows that the nine TARP recipients collectively received U.S.$175 billion in subsidy and in 2008 incurred collectively U.S$81.4 billion in losses or U.S.$63,630 per employee. Despite this unprecedented bad performance, the collective bonus pool was U.S.S32.6 billion or U.S$25,496 per employee. One bank, Merrill Lynch, earned a loss of U.S $467,796 per employee and still managed to pay an average bonus of U.S.$61,017 after its acquisition by Bank of America.

The top four bonus recipients received a combined total of U.S$121 million. More recent information indicates that the bonus payments are potentially far higher still and were not disclosed to shareholders at the time of the acquisition. Prior to the crisis in 2006 Merrill Lynch earned Net Revenue of U.S.$33.781 billion with compensation and benefits of U.S.16.867 billion, with compensation as a percent of Net Revenue at 49.93%. Since investment banking is really about human capital, compensation payouts of around 50% of Net Revenue were the norm prior to the crisis for most of the TARP recipients.

I personally think that compensation; in the form of equity that does not vest for some time, sufficient to see if the activity generating earnings, e.g., subprime lending, is actually viable, is a better form of incentive than a bonus that is determined annually. For example, Macquarie Bank which so far has weathered the financial storm quite well, has made a practice of longer than usual vesting periods. However, compensation schemes and the amounts involved have to be left to the discretion of the owners/shareholders. In the case of banks that would otherwise have failed that have been bailed out by TARP there is no longer any clear-cut owner/shareholder. This is the problem.

Particularly, the Merrill Lynch bonus payments made after it was known that executives had generated huge losses, not gains from subprime lending, are egregious. Without the billions in TARP funding Merrill Lynch would have been bankrupt and failed executives would have missed out, just as they did at Lehman Bros.

Prior to the bailouts, bonuses and other compensation paid to executives would need to be sustainable out of income. The requirement for sustainability means that executives have a requirement to perform in order to go on receiving huge compensation. TARP and other bailouts put and end to this in preparation for even bigger disasters and failures that we have not yet seen. Effectively, almost all market discipline has been removed by defacto nationalisation of banks. While the U.S. banking system may fortunately still seem very different from that of the failed Soviet Union, widespread bailouts have been pushing the system in the direction of systemic failure.

Given that the U.S. Treasury deemed these banks too big to fail, despite allowing Lehman Bros to go under with huge losses, it probably has little choice but to continue paying subsidies to keep the worst-managed banks making the largest losses and with the highest bonus payments afloat. The U.S. Treasury could directly intervene in an attempt to take over the daily running of some of these banks with outcomes likely to be even worse, including departure of key executives.

The U.K. experience is very enlightening. Even after Northern Rock was bailed out by the UK Treasury (taxpayer), taxpayer funds continued to be used to make loans at 125% of (optimistic) valuations (*The Guardian*, March 20, 2009). Hence, it is not clear that the U.K. Government has managed bailed-out institutions any better than the old failed management. Inevitably, like an

investor's worst nightmare, both the U.S. and U.K. Governments are likely to go on pouring vast taxpayer funds in failing institutions with no clear exit strategy–the Vietnam War all over again.

Apart from bailout funds the Small Business Administration arm of the U.S. Government has purchased U.S.$2.1 billion in bad loans from lenders in 2008 with the losses set to rise in 2009. Many of these defaulting borrowers are small businesses such as coffee shops and the like. In addition, many of the recipients of TARP funding, such as Bank of America which has written off nearly 7,000 loans worth $238m since 2007, are being forced to write off more loans (see *SMH* 29/07/09).

While the smaller banks have lobbied the Government to change the system from guaranteeing wholesale funds to guaranteeing individual mortgages to remove the discrimination against banks with lower credit rankings, I am strongly opposed to this idea. Treasury and the Government do not have the skills to discriminate between good and bad borrowers. In effect, they are being asked to set up a new government-owned bank to compete with the major banks. This would be a recipe for disaster, as would have been the attempt by Prime Minister Chifley to nationalise the banks after the Second World War had he and the Labor Party succeeded.

Recently, Glenn Stevens, the Governor of the Reserve Bank stated (see Malcolm Maiden, *SMH*, 29/07/09): "For their part, banks will need to reduce their reliance on the extended guarantees and stand on their own feet before too much longer. The banks of the United States and Europe are starting down this path on their wholesale issuance, having recognised that it is in their own interests to do so. It would make sense for Australian banks, which have accounted for 10 per cent of global issuance of government-guaranteed bank debt over the past nine months, to step up their efforts to do likewise."

While I agree with this statement, I think the Australian Government needs to do more to wind up the scheme before similar moral hazard problems strike in the Australian context, as they have in the U.S. It could do so by lifting the charges to the point where banks no longer wish to avail themselves of the scheme. If some of the most profitable banks in the world cannot stand on their own two feet, something is seriously wrong. If the scheme is allowed to linger on with ever increasing guaranteed borrowings, there is always the likelihood of major bankruptcies and defaults. Banks and their shareholders are not responsible for their actions when they borrow with governmental guarantees. The taxpayer is, but other than voting the government out, can do very little about it. In order to protect the Australian taxpayer and solvency of Australian banks, the Government and Treasury should act now to phase out the scheme.